

PRESIDENT'S MESSAGE

Pensions in the 21st Century



This issue of *Region Focus* features a look at the financial difficulties facing many public-sector pension systems in the United States. Broader-based government-run benefit programs, such as Social Security, have well-publicized funding challenges as well. But such problems are not limited to the public sector. More and more private companies are freezing their pension plans or asking

workers for concessions as retirement liabilities mount.

Most of these private plans are backed by the Pension Benefit Guaranty Corp. (PBGC), the 1974-created government agency that covers about 44 million workers and retirees participating in more than 30,000 private-sector defined benefit pension plans. The agency is financed largely by insurance premiums paid by companies, but those premiums might prove insufficient to cover future liabilities. In fact, a taxpayer bailout is a growing possibility with the rising number of firms having to turn their pensions over to the PBGC.

In the last five years, according to the PBGC, claims from employer pension plans totaled \$14.3 billion, representing 70 percent of all the claims incurred since the agency's creation more than 30 years ago. The PBGC's deficit now nears \$23 billion. Given these problems, it's worth asking why firms adopted defined benefit pensions in the first place. This question is especially interesting given alternatives like defined contribution 401(k) plans, which carry none of the risk but can provide many of the same financial benefits to workers.

First, some businesses undoubtedly adopted defined benefit pension plans for sound business reasons — or, at least, what appeared to be sound business reasons. For certain kinds of industries, workers might accumulate valuable information on the job over time. For others, the cost of recruitment might be especially high. So it's beneficial to have long-term employees. In those cases, defined benefit pensions — which are often based on years of service to a company — might be seen as useful enticements.

In fact, it was with this purpose in mind that among the very first private pensions were those adopted by railroads around the turn of the 20th century. In the case of railroads, the objective was, in part, to ease out older workers, many of whom had aged beyond the point where they were able to do their jobs well. As economist Steven Sass, formerly with the Federal Reserve Bank of Boston, wrote in a book about private pensions, the civilized way to institute a

mandatory retirement age was to couple it with a pension. The railroad pension system helped attract and retain the right kind of people, and let them go at the right time.

But it's not clear that this kind of argument makes as much sense in today's world. Job mobility is increasingly important to workers, who tend to spend their careers jumping from organization to organization in search of better opportunities. As a recent Federal Reserve Board study put it: "In the current environment, certain workers and firms prefer pension plans that do not penalize job change."

Also, many companies instituted defined benefit pensions during periods when those firms had very large shares of their respective markets. With revenues rolling in, it seemed reasonable that they could promise generous benefits — and deliver the goods when the time came. But increased competition has cut into their bottom lines and made once-reasonable assumptions about benefits now untenable.

Public policy probably has played a role, as well, in the development of defined pension plans. When firms have been hamstrung in their ability to negotiate with employees on wages, due to government controls, they have often turned to benefit increases as an alternative. But it hasn't just been during such periods that companies have used more generous benefits as an attractive bargaining chip. Witness the case of Trans World Airlines increasing pension benefits in the 1990s so that employees would take wage concessions — even as the air carrier was in bankruptcy protection.

Such decisions, one has to believe, are affected by the existence of the PBGC backstop. In weighing whether to increase benefits or fully fund their plans, firms carry the assumption that, should they someday go bankrupt, it won't matter because the PBGC will be there to protect workers by providing partial coverage of their pensions. At its core the PBGC is a form of insurance, the intent of which is to spread and share risk. Reforms ought to concentrate on reducing incentives for firms to deliberately shift risks onto the PBGC, perhaps through careful implementation of funding requirements and charging premiums based on credit risk. Beyond that, as with all forms of insurance where the moral hazard problem is significant, we should think hard about whether pension insurance ought to be more limited, or even withdrawn altogether.

JEFFREY M. LACKER
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND